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NACCO Industries, Inc. (NC)

Q1 2019 Earnings Call

CORPORATE PARTICIPANTS

Christina Kmetko

Investor Relations Consultant, NACCO Industries, Inc.

Elizabeth I. Loveman

Vice President & Controller, NACCO Industries, Inc.

John C. Butler

President, Chief Executive Officer & Director and President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.

OTHER PARTICIPANTS

Mitchell Lolley

Analyst, Nixon Capital LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Denise, and I'll be your conference operator today. At this time, I would like to welcome everyone to the NACCO Industries' Q1 2019 Earnings Conference. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions]

I'd like to turn the call over to Christina Kmetko. Please go ahead.

Christina Kmetko

Investor Relations Consultant, NACCO Industries, Inc.

Thank you. Good morning, everyone, and welcome to our 2019 first quarter earnings call. I am Christina Kmetko and I am responsible for Investor Relations at NACCO Industries. I will be providing a brief overview of our quarterly results and business outlook, and then I will open up the call for your questions.

Joining me today are J.C. Butler, President and Chief Executive Officer of both NACCO and North American Coal; and Elizabeth Loveman, NACCO's Vice President and Controller. Yesterday, we published our first quarter 2019 results and filed our 10-Q. Copies of our earnings release and 10-Q are available on our website. For anyone who is not able to listen to today's entire call, an archived version of this webcast will be on our website later this afternoon and available for approximately 12 months.

As we begin, I would like to remind participants that this conference call may contain certain forward-looking statements. These statements are subject to a number of risks and uncertainties that could cause actual results to differ materially from those expressed in the forward-looking statements made here today in either our prepared remarks or during the following question-and-answer session.

We disclaim any obligation to update these forward-looking statements which may not be updated until our next quarterly conference call, if at all. Additional information regarding these risks and uncertainties were set forth in our earnings release and in our 10-Q.

Before we talk about the quarter, let me give you an overview of a change in our segment reporting. We are now reporting three segments: Coal Mining, North American Mining, and Minerals Management. Previously, we reported North American Coal and NACCO and other.

The Coal Mining segment operates surface coal mines pursuant to a service-based business model under long-term contracts. This segment includes our legacy surface coal mining operations, both consolidated and unconsolidated.

The North American Mining segment provides value-added contract mining services for producers of aggregates and other minerals, primarily operating and maintaining draglines and other equipment. We have discussed the North American Mining business previously but its financial results have never been reported separately. North American Mining also has consolidated and unconsolidated operations.

The Minerals Management segment represents the business that generates the royalty income we have discussed in the past. It promotes the development of our oil, gas and coal reserves, generating income primarily from royalty-based lease payments from third parties. There are also certain unallocated items that are not directly attributable to one of these three segments.

These unallocated items primarily include administrative costs related to being a public company, as well as the financial results of our new mitigation banking business, Mitigation Resources of North America and Bellaire Corporation. We provided information for the full year and four quarters of 2018 under the new segment structure in our earnings release. We are only disclosing segment results to the operating profit line and discussion of anything below operating profit or in relation to our balance sheet in cash flows is on a consolidated basis.

Now, let me discuss our 2019 first quarter. I'll cover our consolidated results first and then provide the highlights for each segment. On a consolidated basis, our operating profit increased to \$16.4 million from \$9.7 million in last year's first quarter. Our consolidated net income increased to \$15 million or \$2.15 per share for the 2019 first quarter, up from \$8.2 million or \$1.18 per share last year. Our effective income tax rate was 13.4% compared with 9% last year.

The primary driver of the improvement in our consolidated result was a substantial increase in operating profit at our Minerals Management segment due to an increase in the number of wells operated by third parties to extract natural gas from our Ohio Mineral Reserve. The increase in the Minerals Management segment was partly offset by lower operating profit at both the Coal Mining and North American Mining segments.

At our Coal Mining segment, operating profit decreased due to the absence of a \$1 million favorable adjustment to Centennial's asset retirement obligation, which was recorded in the prior year first quarter, and an increase in selling, general and administrative expenses. An increase in our earnings of the unconsolidated coal operations partially offset those items. At North American Mining, operating profit decreased primarily because of increased selling, general and administrative expenses which included additional business development costs. Those are the significant factors affecting the first quarter results.

Now let me turn to our outlook. At the Coal Mining segment, we expect overall deliveries to decrease moderately for the 2019 full year. Operating profit is also expected to decrease from the prior year as a result of the absence of the favorable \$3 million contractual settlement and \$2.8 million in favorable adjustments to mine reclamation liabilities recognized in 2018. Excluding these favorable prior year items, we expect 2019 operating profit to be comparable to 2018 as improved operating results at Mississippi Lignite Mining Company are expected to be offset by reduced income at the unconsolidated Coal Mining operations resulting from fewer tons delivered.

In 2019, we expect North American Mining deliveries to decrease modestly compared with 2018. Operating profit is also expected to decrease compared to last year. Improved results of the unconsolidated operations attributable to increased customer requirements and new customer contracts are expected to be offset by higher operating expenses, due in part to business development activities. Operating expenses for the remaining quarters in 2019 are expected to be comparable to this quarter's run rate.

Finally, as I mentioned previously, our Minerals Management segment's operating profit increased significantly during the first quarter. For the remainder of 2019, we expect royalty income to increase over the comparable 2018 period, but at a lower rate than we realized in the first quarter. However, it is important to note these expectations for royalty income are dependent on a number of factors outside of our control as we mentioned in the earnings release.

In summary, overall, we expect our consolidated 2019 net income to increase significantly compared with last year as a result of higher operating profit as well as an anticipated decrease in our interest expense from reduced borrowing and higher interest income on cash investments. We are forecasting an effective income tax rate in the range of 13% to 15%.

Lastly, we expect capital expenditures to be approximately \$23 million for the 2019 full year. However, even with the increased capital expenditures, we expect our consolidated cash flow before financing activities to increase significantly over last year.

Before I open up the call for questions, let me provide a few final pieces of information about our balance sheet. We ended the fourth quarter with consolidated cash on hand of \$79.1 million and debt of \$12 million. This compares to consolidated cash on hand of \$85.3 million and debt of \$11 million at the end of 2018.

Also during the fourth quarter, we repurchased approximately 36,300 shares of our Class A common stock for an aggregate purchase price of approximately \$1.3 million under our \$25 million stock repurchase program. Since the beginning of our program in February 2018, we have repurchased a total of approximately 75,000 shares for an aggregate purchase price of \$2.6 million.

That concludes my prepared remarks. I will now open up the call for your questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from Mitchell Lolley with Nixon Capital. Your line is open.

Mitchell Lolley

Analyst, Nixon Capital LLC

Q

Hi, good morning.

Elizabeth I. Loveman

Vice President & Controller, NACCO Industries, Inc.

A

Good morning.

John C. Butler

President, Chief Executive Officer & Director and President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.

A

Good morning.

Mitchell Lolley

Analyst, Nixon Capital LLC

Q

So the extra segment disclosure is quite interesting and it makes me think of several questions to ask and first, maybe starting off with the bigger picture. It sounds like there has not been a meaningful change to the 2019 outlook that you laid out on the fourth quarter call. I guess, a major stand out is the massive jump in royalty income but other than that it sounds like the Coal business and the North American Mining operations are performing about in line with their expectations earlier this year. Is that fair?

John C. Butler

President, Chief Executive Officer & Director and President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.

A

That's fair.

Mitchell Lolley

Analyst, Nixon Capital LLC

Q

Okay. So now addressing the royalty income component. I mean, you generated \$11.7 million of royalty operating profit in the first quarter which is actually more than what you've historically generated in a typical year. So just a couple of questions on that. First, was there anything unusual that drove the huge spike in royalty income this quarter like possibly the receipt of upfront lease bonus payments or was a lot of the royalty income actually just tied to increased production activity in the quarter?

John C. Butler

President, Chief Executive Officer & Director and President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.

A

This was entirely production activity.

Mitchell Lolley

Analyst, Nixon Capital LLC

Q

Okay. And...

Elizabeth I. Loveman

Vice President & Contoller, NACCO Industries, Inc.

And can I add...

[indiscernible] (00:09:55)

A

Elizabeth I. Loveman

Vice President & Contoller, NACCO Industries, Inc.

Can I add one thing? For upfront lease bonus payments, we recognized that over the primary lease term, we wouldn't see a spike in earnings as a result of that. That...

[indiscernible] (00:10:05)

A

Elizabeth I. Loveman

Vice President & Contoller, NACCO Industries, Inc.

... recognized over five years and so, you wouldn't ever see a spike because of lease bonus payments.

A

Mitchell Lolley

Analyst, Nixon Capital LLC

Okay. And J.C., based on what you wrote in your annual shareholder letter, is it accurate to assume that you guys are actively pursuing more growth opportunities in the royalty business?

Q

John C. Butler

President, Chief Executive Officer & Director and President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.

We are. I mean one of the reasons we have this segment is because we have these reserves that we've owned for a very long time and because of technological developments with hydraulic fracturing and infrastructure that's come into Southeastern Ohio, in particular, it's really turned into a very substantial income stream.

The development of that is really up to the companies that develop and produce from those wells. It's not something that we do directly that we benefit from the royalties that come out of that. We've recently hired an experienced petroleum engineer that got expertise in this area to help us optimize, maximize our income stream that comes out of these reserves but also look at ways that we might strategically expand that in the future.

A

Mitchell Lolley

Analyst, Nixon Capital LLC

And then just to make sure, I'm understanding the earnings release correctly. You're saying that royalty income for the remaining three quarters of 2019 should also increase year-over-year?

Q

John C. Butler

President, Chief Executive Officer & Director and President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.

Yes, should increase year-over-year. Exactly how much, as we've said in the earnings release and in the risk factors as well, so much of this is up to what the third-party producers do. If natural gas prices drop, they can decide to shut off the wells. Every well has its own unique decline curve. I mean there's lots of other things that can happen. They also could develop additional wells that could increase it but we're not really in control of any of that but we do expect increased income year-over-year.

A

Christina Kmetko

Investor Relations Consultant, NACCO Industries, Inc.

A

Mitch, just to clarify, the one thing we did say is we don't expect it to be at the rate that it was in the first quarter.

John C. Butler

President, Chief Executive Officer & Director and President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.

A

Right.

Mitchell Lolley

Analyst, Nixon Capital LLC

Q

Right. No, I understand that. If we can move to the limestone business. It's pretty interesting to see with the new segment disclosure that North American Mining actually generates a material amount of profit for the overall company. And I was wondering if you could maybe start by talking about some of the business development initiatives that you're pursuing in 2019 for North American Mining?

John C. Butler

President, Chief Executive Officer & Director and President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.

A

Well, I mean I can speak generally about that. I'm not going to provide any specifics. North American Mining is a segment, probably, the best way to describe that is it's the home for business development that's not coal. Any coal business development, of course, would be in that segment. So, business development for North American Mining, of course, will be expanding its existing core business, which is really maintaining and operating draglines for limerock producers largely in Florida.

As you know, we've been successful the last couple of years growing that business pretty substantially in Florida. We've recently added a contract outside of Florida. We've picked up equipment beyond draglines and we've added very small operation that mines sand, so it's beyond limestone. We're going to continue to look for ways to expand that business as I say beyond draglines, beyond Florida, beyond limerock. In the perfect world, we would also be able to expand the scope of what we do for a quarry operator or a mineral producer so that we ran really our integrated solutions business model like we do at the coal business, where we really run the entire mining operation and then hand off the coal to a customer who in a mine-mouth relationship then produces electricity or in a couple instances produces activated carbon.

In a perfect world, we'd operate for a limerock quarry or a mineral producer where we would run the entire mining operation and then hand off the product to them for transformation into whatever product it is that they sell. So we've got a lot of efforts focused on this. We've added people to North American Mining, specifically, dedicated to business development. We also are tapping into resources that we have at The North American Coal and NACCO Industries parent to help with that. And we from time-to-time borrow people from our mining operations to come help on special projects. So that's all contributed to, I think, the business development success that we have seen and hopefully, we will continue to see.

Mitchell Lolley

Analyst, Nixon Capital LLC

Q

And this year, I was wondering to what extent are you taking advantage of this really high royalty income stream and maybe using that to fuel some of the incremental business development activity at North American Mining. I mean, is that how you think about it at all?

John C. Butler

President, Chief Executive Officer & Director and President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.

A

I mean, sure, we've got a very conservative balance sheet which allows us to really focus on doing the right things for the business over the long term including business development. North American Mining has been a real focus of ours in growth for the last really kind of three years, is when we sort of decided to put a lot of effort into this. So, sure, using some of the resources that we have available in the company to support growth, I think, makes a lot of sense.

Mitchell Lolley

Analyst, Nixon Capital LLC

Q

And I also noticed, I guess this was last quarter and you mentioned it, that you recently won your first sand mining contract with King William in Virginia, and that's also the first contract North American Mining has won outside of Florida. So, could you talk about some of the value NACCO's mining services add to quarry owners and why some of these big companies like Martin Marietta or Cemex decide to hire North American Mining as a service partner?

John C. Butler

President, Chief Executive Officer & Director and President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.

A

Mitch, sure. This is what we do. We're experts at mining, whether it's aggregates or coal or other minerals. We understand how to optimize the equipment. We understand how to staff it. We understand the full dynamic inside mining. North American Mining business, of course, grew out of the expertise that we developed in Coal Mining. We run the company as a single company. So, all these skills transfer between businesses. This was maybe in the annual report letter, we feel that we can bring our expertise to the mining operation at a quarry for instance, and allow the customer, if we focus on the mining, the customer can then focus on what it really does best, what their core skills, which are crushing and processing the limerock and instance of a limerock quarry, and then marketing and selling it. Those aren't skills that we have. But when you think about it, it's kind of the same thing as a coal mine with a mine-mouth power plant. It's really a single thing that has to operate in perfect coordination to be successful. We go to a quarry and do the same thing. We can really be the experts at mining and allow them to be the experts at crushing and sizing their product and selling it.

Mitchell Lolley

Analyst, Nixon Capital LLC

Q

And once you win a contract with, let's say, Martin Marietta, some of the other larger players, does that kind of set you up for, I mean, does it get your foot in the door for later wins at some of their other quarries or...?

John C. Butler

President, Chief Executive Officer & Director and President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.

A

Well, I mean, I will tell you that our future success is dependent upon our past and current success. We're pretty open about the fact that we view ourselves as a service business and the quality of the work that we do depends on our ability to have additional opportunities in the future. I've got a lot of confidence in the work that we do and the quality that we bring to mining, the discipline that we bring to that. So sure, we're, of course, hopeful that the work that we do with any of these customers can lead to more opportunities.

Mitchell Lolley

Analyst, Nixon Capital LLC

Q

Okay. Now switching topics just a little bit. I noticed you bought back more stock in the first quarter than you have in quite some time. Could you talk about what drove that decision?

John C. Butler

President, Chief Executive Officer & Director and President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.

A

We've had stock repurchase programs in place for a long time. I think some companies have a stock repurchase strategy. They just constantly are buying stocks because it makes Wall Street happy, but they're always buying stock. We believe that it makes sense to buy stock in a company when there's a good ROI. We're spending shareholder money and so we buy stock when we think it makes sense to buy stock. I will tell you, we do it through, largely through, 10b-5 programs with broker dealers. So it's not like we're on a daily basis playing with any of this. We sort of set a program in place and then let it execute.

Mitchell Lolley

Analyst, Nixon Capital LLC

Q

Okay. And then lastly, so you're expecting to generate significantly more than \$36 million of cash flow before financing this year. And that's net of all expenses and capital expenditures, so it's a lot of cash that you'll be able to allocate, however, you see fit. Plus you have \$79 million or a little more than that, \$79.1 million of cash sitting on the balance sheet. So under what circumstances, would you return some of that cash to shareholders in the form of a special dividend? I mean, the current payout is something like \$5 million a year, so it's not like you have issues covering that.

John C. Butler

President, Chief Executive Officer & Director and President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.

A

Well, if you look at the history of NACCO Industries and it's many forms even back when we had a Hyster-Yale and Hamilton Beach as part of our company. We've always had a pretty disciplined approach of returning capital to shareholders through a reasonable dividend program and periodic share repurchase programs. We have only once that I can remember, and I've been here 24 years, only once can I remember paying out a special dividend. We're pretty clear in our annual report letter that we run the company with an eye towards taxable shareholders with a long-term perspective. I don't know that paying a special dividend is necessarily in the best interest of taxable shareholders.

Mitchell Lolley

Analyst, Nixon Capital LLC

Q

All right. Well, thanks very much. I appreciate it.

John C. Butler

President, Chief Executive Officer & Director and President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.

A

All right. Thanks for your continued interest. We appreciate your call and your questions.

Operator: [Operator Instructions] And there are no further questions queued up at this time. I'll turn the call back over to management.

Christina Kmetko

Investor Relations Consultant, NACCO Industries, Inc.

Thank you very much. If you do have any follow-up questions, my phone number is in the earnings release. Please feel free to reach out and I will follow up with you then. Thank you. Have a great day.

Operator: Thank you for participating in today's NACCO Industries Q1 2019 Earnings Conference Call. This call will be available for replay beginning at 12:00 PM Eastern Standard Time today through 11:59 Eastern Standard Time on May 9, 2019. The conference ID number for the replay is 2378565. Again, the conference ID number for the replay is 2378565. The number to dial for the replay is 1-800-859-2056. This concludes today's conference call. You may now disconnect.

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